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Windpower Monthly News Magazine

July, 2006:39 [[Order this issue](#)]

Precedent setting project finance -- Offshore wind takes banks to the cutting edge of multi-contracting

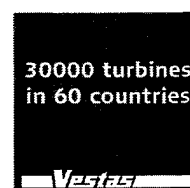
Bankers are on the way to concluding a landmark deal for the wind power industry -- the first project financing for an offshore wind farm in which lenders will take not only the operational risk, but also the construction and commissioning risk on the assets. European banks Dexia and Rabobank are structuring the transaction to help fund the 120 MW **Q7** wind power development, to be built in the Dutch North Sea.

Progress on offshore wind development slowed rapidly last year when turbine suppliers announced themselves unwilling to offer the same guarantees for turnkey completion of offshore projects as they do for projects on land. Vestas said that while it had taken on some turnkey offshore commitments in the past, it would no longer do so, for fear of being overly exposed when things went wrong (Windpower Monthly, December 2005). Siemens pulled out of a planned turnkey project on Centrica's offshore projects in the UK at the last minute for the same reason.

The **Q7** deal is the first to have found a way out of the stalemate. It will establish benchmarks as the first bank financing of the so-called "multi-contracting" approach that many now see as the way forward for offshore wind development.

Consortium

The **Q7** sponsors are a consortium of Dutch utility Eneco, wind developer Econcern subsidiary Evelop and investor group EIH (Windpower Monthly, May 2005). Site work started in the spring some 23 kilometres offshore of IJmuiden. Nominal build-out costs on the project are around EUR 300 million. Including the various standby facilities generally required under a project financing structure, the full upfront funding requirement is around EUR 380 million, of which banks will be providing some EUR 180 million as debt. The balance will comprise EUR 120 million of so-called "tax equity," essentially government subsidy structured as a tax break for the sponsors, and EUR 80 million of direct



sponsor equity.

It will not be the first time that banks have lent money to an offshore wind farm: a UK offshore development was included in the portfolio of Innogy projects refinanced in a special purpose vehicle called Beaufort Wind more than a year ago. But it is set to mark the first time that bank lenders take on exposure to what they see as the considerable risks inherent in successfully constructing on time and to budget a large offshore wind generation project.

On time and to budget are key watchwords in limited recourse wind project financing, where banks have no claim on project shareholders should an asset fail to generate sufficient debt-service during its contracted life. Topping bankers' concerns is the spectre of cost overruns eating into the equity buffer of the project sponsor and delays hitting the repayment schedule, alongside the more basic issue of operational performance.

Onshore, it is standard procedure for a wind turbine supplier to act as turnkey contractor for a fixed total price, handing over a completed project ready for the owner to turn the start key. Banks will price the project loan during the construction phase on the basis of the contractor's own credit rating, or perhaps that of the sponsor if it is happy to wrap the contractor risk. As such the deal is not seen to be truly non-recourse until the turbines are turning satisfactorily.

Offshore is a different financing environment and a relatively untested one in which turnkey and similar completion guarantee mechanisms have yet to bed down across the contractor industry. They are not impossible to structure: the combination of Vestas and Ballast Nedam is providing such a guarantee on the near-shore Noordzeewind project, jointly sponsored by Shell and Nuon, also in Dutch waters and currently building.

What makes offshore wind projects fundamentally different from wind projects on land is that they require two separate skill-sets: wind turbine installation and offshore engineering. To date these are quite distinct and found in separate industries. Under a turnkey structure, the offshore engineering side of the contracting team is undertaking to at least partly guarantee the turbine side and vice versa. As Ballast Nedam has previously stated (Windpower Monthly, July 2005), this "contravenes the first rule of risk management: only manage risks in areas you know." It did not add that contravening good risk-management practice in this way demands a considerable premium be charged for the turnkey undertaking. Many developers, particularly those whose capital constraints require them to seek external financing in the first place, see paying this premium as simply uneconomic.

New structure

The solution to the impasse appears to be emerging with **Q7**. Would-be offshore developers and potential offshore project lenders have been anticipating for some time a "project management" structure of multi-contracts for a significant proportion of offshore wind financings, at least until the offshore wind contracting industry beds down with a sufficient track record of successful experience to have reduced the perceived risk. The project management structure is predicated on developers being unwilling to pay the premium required to vest the overall financial risk of failure in the construction and commissioning phase with a single responsible third party. That leaves their bankers foregoing the one-stop-shop ease of a turnkey-type arrangement and instead having to take responsibility for carefully constructing a web of contracts parcelling out the various risks to those best able to absorb them.

In this multi-contracting structure, what is called "interface risk" also becomes far more important. Without a single-source, comprehensive wrap on the project up to the point of handing it over to the owner, the project company -- and by extension its bankers -- are taking on the additional risk of managing how all the separate contracts fit together in practice. They may have failed to foresee certain risks on the margin of each contractor's ambit, which subsequently fall through the cracks to suddenly appear as project company and lender exposure.

By following the project management route rather than the turnkey route, **Q7** is on the way to becoming the first commercial bank deal to reach financial close anywhere in the world. As such it is expected to set precedents for a wave of European offshore project financings to follow, particularly with regard to managing the interface risk between the project company and its construction phase counterparties. For **Q7**, these include turbine manufacturer Vestas, foundation suppliers the Smulders Group and electrical engineers Fabricom.

Q7 will not be handed over before early 2008, so with Dexia and Rabobank intent on closing the project deal before the end of the year they will be exposed to a considerable chunk of offshore construction risk. So too will be a syndicate of other bank lenders being brought into the deal by the two lead banks.

Comfort zone

In return for taking on new risks, bank lenders will demand more comfort in other areas. Unlike a wind farm on land, where the banks are prepared to lend up to 90% of the project's cost, the leverage for **Q7** is far lower at just under 50%. And while loans for onshore projects are now

conventionally priced around 1% over bank base rates or even less, this margin on **Q7** will probably be closer to 2%.

Tenor on the loan will be the construction period, plus the following ten years for which the project will qualify for the Dutch "green" premium paid over the "grey" power market price. But while the grey market price is normally variable over time, the power purchase agreement (PPA) under which the **Q7** capacity will be sold on to utilities apparently also fixes the grey element of the payment throughout, to give lenders maximum surety on future revenue streams.

On the current timetable, the **Q7** deal looks likely to be the first bank financing of an offshore wind plant which takes aboard construction risk to reach closure. Right now, however, banks are also being asked to bid for the arranging mandate on a project financing to help fund the C-Power project offshore of Belgium, which numbers French state utility Electricité de France among its sponsors. This too might also see bankers being asked to take on pre-completion risk. It is thought the deal will move quickly once funding sources have been selected. Danish utility DONG is also in the bank market right now looking for funds for offshore wind. In its case, however, the money will be refinancing already operational wind power stations in Denmark and the UK, a much easier proposition for lenders than diving into the unknown.

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